# The Case For and Against Valeant Pharmaceuticals

## Description

**Valeant Pharmaceuticals** (TSX:VRX)(NYSE: VRX) has been in the news recently based on its interest in **Allergan** (NYSE: AGN).



Valeant, which has a market cap of more than $40 billion, aspires to become one of the great pharmaceutical companies in the world, rivalling **Novartis** and **Johnson & Johnson**. For Valeant to become that big in a relatively short period, it needs to hunt for big elephants to move the needle.

What does this mean for current and potential investors?

**Three reasons for optimism**

**1. Growth potential:** Because Valeant wants to be one of the great pharma companies, it will continue to grow aggressively via merger and acquisitions. It has grown at an average compound annual growth rate of 23.1% per year from 2004-2013 and as a result, its shareholders have been well rewarded, beating both the S&P 500 and TSX during the same time period.

**2. It's not really a pharma business:** Historically, the industry can be broadly divided into three categories — pharmaceuticals (high risk/high reward), over-the-counter (lower margin, but repeat business), and medical equipment (decent margins, incremental innovations). For Valeant to succeed, it cannot afford the significant money needed for research and development as it needs sustainable cash flows to cover debt. Thus, Valeant is transforming itself into a more of a consumer packaged goods business model, where cash flows will be more predictable.

**3. Valuation matters:** Valeant currently trades between 13.5 to 14 estimated 2014 forward price-to-earnings (PE) ratio and 12 to 12.5 estimated 2015 forward PE. This would imply that Valeant is trading at a PE range that is on average, near the lower end of historic market averages, making it a decent valuation.

**Three reasons for caution**

**1. High debt needed to finance future growth:** With recent string of acquisitions, including the acquisition of Bausch + Lomb in 2013, Valeant's long-term debt to assets ratio is now a whopping 61.4% as of 2013, up from 18.4% as of 2009. Comparatively, Novartis has a long-term debt to asset ratio of 8.9% as of 2013 (Johnson and Johnson's is slightly higher).

**2. If you are not using debt, you are using equity:** Now, if you are not using debt to finance large acquisitions, you pretty much have to use equity. It is *very* painful for shareholders to see equity being used given the relatively low-interest environment.

**3. Making mergers work is a tough business:** Given its size, Valeant needs to hunt for bigger and bigger targets to achieve meaningful growth. Given the historical high probability of merger and acquisition failures, there is enormous risk. On average, merger and acquisitions have a less than 50% chance of succeeding. And it just takes one bad acquisition for shareholders to lose significant value.

Ultimately, investors need to balance the opportunities and risks. While Valeant delivered significant shareholder value over the past years, its aggressiveness to grow via merger and acquisitions may ultimately pose significant risk for investors.

**CATEGORY**

1. Investing



**TICKERS GLOBAL**

1. NYSE:BHC (Bausch Health Companies Inc.)
2. TSX:BHC (Bausch Health Companies Inc.)

**Category**

1. Investing

**Date**
2025/08/28
**Date Created**
2014/06/19
**Author**
patrickli